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SIPDIS

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TAGS: ECON ETRD CE ECONOMICS
SUBJECT: Post-MFA Challenges Twist Garment Sector Knickers

REF: (A) 04 Colombo 1604 (B) 04 Colombo 1271

¶1. (U) Summary: Although, there was much concern in the last few months of 2004 about the end of the Multi-Fiber Agreement (MFA) and the possible loss of up to 30,000 jobs, this problem paled in comparison with the enormous loss of over 30,000 lives from the tsunami on the eve of the MFA expiry. Now, four months after the two events, the Sri Lankan garment industry has begun to feel the impact of Chinese competition. As expected, small and medium players with low-tech systems are facing problems. Yet, even the large players have expressed surprise at the intensity of the increased Chinese exports. Sri Lanka's apparel industry still pins it hopes on expectations of preferential access to US and EU markets. Sri Lanka's Joint Apparel Association Forum (JAAF) continues to predict that overall garment exports from Sri Lanka will reach more than USD 4 Billion by 2007. End Summary.

Recent trends--Exports up January-February but sowing
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¶2. (U) In spite of increased competition in the run up to the MFA expiry, Sri Lankan textile and apparel exports rose 9 percent in 2004 to USD 2.8 billion and accounted for 49 percent of total export revenue. In volume terms, apparel exports were up 8 percent while prices rose by one percent, according to Central Bank statistics. The positive trend in apparel exports continued into the first two months of 2005 based on orders placed through 2004. March exports, however, were flat compared with March 2004 figures. Presently, there is no indication of how much apparel exports from Sri Lanka will change during the course of the year. Orders from small and medium companies have been low in March and from July onwards, according to Nihal Seneviratne, Chairman of the Sri Lanka Chamber of Garment Exporters (SLCGE), which represents small and medium exporters. (According to Seneviratne, in previous years, exporters would have received confirmed orders by May for July-August). According to EU Trade Commission Officials, apparel exports from Sri Lanka to EU have declined sharply through April. Exports to the US increased during this period.

Top brands are still here but with new sourcing plans
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¶3. (U) Sri Lanka continues to attract top brands and buying houses such as May Department Stores, Next, Marks and Spencer, Nike, Gap and Limited Brands. Some changing trends have emerged. According to apparel industry sources, buyers are in the process of rationalizing the supplier base and relying on large manufacturers. They are looking for manufacturers able to provide product development, deliver quick turnaround times, create new domestic input sourcing mechanisms, develop links with overseas suppliers and improve productivity. Hence, Sri Lanka's largest apparel companies who collectively supply about 80 percent of exports should do well, as they have been focused on these very tasks for some time. These companies recorded substantial growth in 2004. MAS Holdings, the largest apparel exporter and a world leader in intimate apparel, experienced 22 percent growth in export earnings in 2004 and expects a growth of 10 percent in 2005. Brandix, the second largest apparel exporter, recorded a 5 percent growth in 2004 and forecasts a 26 percent growth in 2005. Hirdaramani group, another large exporter, had flat growth in 2004, and expects exports to pick up by about 10 percent in 2005. Large orders and increased productivity have assisted these producers in adjusting to price pressures from buyers.

Hoping for preferential access and China safeguards
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¶4. (U) Manufacturers in Sri Lanka, lacking a well-developed textile base and reliant on imports, have been pining for preferential access to Sri Lanka's two major markets, the US and EU, to survive in the post MFA era. Most of these hopes have failed to materialize so far, causing concern in the industry. The only positive recent move was when Sri

Lanka became eligible for special incentive arrangements with the EU under the EU Generalized System of Preferences (GSP) scheme in February 2004. These concessions were given in response to Sri Lanka's adherence to core ILO labor standards. Under this scheme Sri Lankan garments (meeting Rule of Origin (ROO) requirements) receive 40 percent duty concessions. Consequently, garment exports to the EU rose by 27 percent to $985 million in 2004. With the end of the MFA, however, such concessions have become inadequate to compete with cheaper Chinese and Indian exports. Therefore, Sri Lanka has applied for duty free entry for its garments, under the EU "GSP-plus" scheme now expected to come into force in July 2005. Once the GSP plus benefit becomes operational, however, Sri Lanka's exports will only get limited additional benefits due to tough ROO requirements. Currently, EU ROO require the use of local fabric or fabric from the region. If fabric from the region is used local value addition should be greater than 50 percent to qualify for duty free entry. The EU is considering relaxing ROO requirements to about 30 to 35 percent by year-end. The industry is also lobbying to expand EU ROO to include ASEAN fabric.

¶5. (SBU) Former Sri Lankan Ambassador to the US, Devinda Subasinghe, who has been asked by the JAAF to be its advocate in Washington, said in an email to Econchief, that Sri Lanka could survive with a 35 percent ROO requirement. Meanwhile, a Sri Lankan ministerial delegation visited Europe to lobby for concessions for apparel exports under consideration by the EU for tsunami-hit countries.

¶6. (SBU) Manufacturers in Sri Lanka are also hoping for preferential access to the US. In 2004, the US accounted for 58 percent of garment exports estimated at $1.54 billion or about a quarter of total Sri Lankan exports (all goods). This heavy dependence on the US market is worrisome now as Sri Lanka does not receive any preferential tariff benefits in the US markets and will have to compete directly with China and India. Sri Lanka is hoping that textile exports will receive tariff concessions from the Trade Act of 2005, where Sri Lanka is included as a tsunami-affected country.

¶7. (U) At a recent seminar organized by Friedrich Ebert Stiftung, a German NGO, both the Econchief and a EU Trade Commission representative explained concerns in their respective countries and regions regarding tariff concessions on textile imports and described processes involved in decisions on China-related safeguards. Sri Lankan manufacturers should benefit from the recent US decision to invoke safeguards on textile imports from China. Sri Lanka is quite competitive in all three categories facing safeguard action: cotton shirts and blouses, cotton trousers and underwear.

¶8. (SBU) As expected, smaller manufacturers, who have not improved production processes and do not have ties with suppliers, have started to face serious problems. In addition to a shortfall in orders smaller manufacturers also face problems with regard to financing. Banks, on the look out for MFA expiry, have devised their own ways to minimize risk and losses from the fallout. At an Amcham convened meeting with the Ambassador in 2004, apparel exporters complained that banks had already stopped lending to some small- and medium-sized operators. This trend is continuing. For example, Citibank NA has carried out a special portfolio review of its textile sector that comprises several mid-size companies and has classified companies as winners, survivors, and losers. The bank, which offers short-term facilities tied to the trade cycle, expects to exit from firms falling under the last category as soon as possible. According to SLCGE's Seneviratne some SME factories have already closed operations. However, no reliable statistics are available on the closures.

¶9. (U) Some of the large Sri Lankan firms have also taken other measures to succeed in the quota free era. They have moved operations overseas to be close to suppliers and to markets. For example, MAS Holdings now has facilities in ten countries including China and India. Brandix has opened a factory in Madagascar as well as marketing offices in the US and UK and a sourcing office in Bangalore. Brandix is also looking at opening an apparel factory in India. Some of them have also forged stronger links with domestic input suppliers. For instance, Brandix has small, up-start operations in textiles, thread, buttons and hangers. MAS has invested in an elastic plant and a large nylon lace plant (a joint venture with a French Company).

Government Efforts

¶10. (U) The GSL's primary effort to deal with the MFA expiration has been to seek preferential market access for Sri Lankan garments in the US and EU. Nonetheless, it has also worked with the industry to develop a productivity enhancement program, aimed specifically at small- and

medium-size garment manufacturers. It is also looking at possible Millennium Challenge Account funding to help boost the small and medium enterprise sector, with an eye toward enhancing the prospects of success for those garment manufacturers who can compete, and helping those that cannot in the transition to other business opportunities.

Comment

¶11. (SBU) JAAF's confidence and increased export predictions rest with the larger manufacturers and their efforts to improve productivity and greater supply chain consolidation. Nonetheless, while the largest manufacturers will have to boost employment somewhat to achieve these targets, it is doubtful they would absorb all the potential job losses, without some increased access to either US and EU markets, or new markets in Asia. From an economic perspective the impact of the MFA expiration will have to be closely monitored in Sri Lanka to assess and mitigate effects from unemployment to foreign exchange earnings. On the whole, no one is predicting the apparel sector's imminent demise, but the challenges posed by the quota-free era underscore the importance of economic reforms, incentives for diversification of export industries and the need for increased foreign investment, to help in both diversification and the introduction of greater productivity processes. End Comment.
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